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Monthly Letter on

Economic Conditions
Government Finance

New York, May, 1953

General Business Conditions

THE month of April has been more eventful in the money and security markets than in the trade and industrial situation, which shows no great change from earlier months this year. In a few lines new orders appear to have slackened a little, but a much more pronounced drop would have to occur before production and employment would be materially affected. Supported by well-filled order books, the productive facilities of the country are about as fully engaged as it is ever reasonable to expect, and the output of goods and services in the aggregate is about as great as available supplies of materials and labor will permit. The Federal Reserve Board's industrial production index set another high in March at 242 (1935-39=100). Apparently there has been no falling off in April, although short-lived strikes or materials shortages have hampered operations in a few places.

As seasonal activities open up, employment evidently will reach a new high level. The purchasing power created by this immense productive activity flows through the economy and supports a record volume of trade. Preliminary reports leave little doubt that total retail sales in April, as in preceding months, have run higher than a year ago. Despite feeling in many quarters that the automobile manufacturers are over-optimistic, new car sales thus far in the spring season — at least for the more popular makes — have reached very satisfying totals.

Industrial Prospects

In short, the boom has continued. The increases in bond yields and bank lending rates, which are described subsequently in this Letter, are evidence of the strength of the demand for money, which in turn is a manifestation of the strength of the demand for goods and services. The effect of tightening money and falling bond markets is to check rising demands, and probably these changes have strengthened the opinion that business generally is about as high as it can be expected to go. This will almost certainly be so if money available to finance expansion of instalment purchases of consumer goods should soon begin to reach a limit, as it may in some areas. Upon capital investment, however, the restrictive effects of higher financing costs develop slowly. Programs for plant and equipment expenditures are still moving ahead under strong momentum, as are state and local government construction projects, including civic buildings, schools, hospitals and highways. It seems more likely that a slackening of production, when it occurs, will first appear in automobiles and other consumers' durable goods; for, even with encouraging retail sales, many of these items are being turned out at rates not expected to be maintained through the year. In some of the heavy household appliances curtailment may be imminent.

The steel industry still has all it can do to supply requirements, and must now provide material for a stepped up ammunition program.

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Thus it expects to extend capacity operations at least into the third quarter. Beyond that, continuance of the present level of demand from the automobile and appliance manufacturers seems less certain, and probably there has now been substantial replenishment of inventories depleted during last summer's strike.

The Korean Negotiations

Bearish views of the business outlook based upon the resumption of armistice negotiations in Korea, together with other developments inspiring hope of an easing of international tension, seem to have moderated somewhat since the first impact of the news upon the stock market. Such views must rest on two assumptions. One is that defense expenditures will be cut back sharply. The second is that equivalent increases in non-defense demand will not be forthcoming.

These assumptions require examination. Even while negotiations go on in Korea, new Communist aggression has occurred in Indo-China, helping to bring about a realization that the United States cannot afford to relax its defense position. To be sure, sound defense policy should provide for economy, elimination of waste, and better programming, which may involve cancellations and stretch-outs. The effect of such moves both on demand and on market sentiment is not to be ignored, but neither should their magnitude be overrated. The essential fact is that defense requirements will continue huge, and that any falling off is likely to be minor in its effect on the economy.

To the second assumption, which is equivalent to arguing that peace would necessarily bring depression, Secretary Humphrey gave a forceful and widely applauded answer in his speech of April 20. In terms of real welfare, no one can doubt that the country would be better off if the waste of armament expenditures could be saved, and if budget cuts, tax reduction, and the more complete satisfaction of personal needs and aspirations could be made possible. Business thrives on peace and order. It would be stimulated by tax reduction, not merely because tax cuts would permit people to spend more of their own money as an offset to less government spending, but also because tax reduction would permit tax reform.

In the industries, the necessity to sell more goods to a multitude of private buyers rather than a single government buyer would call for even greater emphasis upon efficiency in production, engineering, design, and sales, in order to produce and distribute goods that people would want at prices they could pay. It would bring to the fore questions of cost, price and income relationships, in which there must be a fair and just balance if people are to be able to exchange their labor and their products with each other on equitable, and therefore practicable, terms. In periods of inflation, when an increasing supply of money supports demand almost regardless of the terms on which goods are offered, the tendency is to lose sight of the necessity for balance in prices and costs. Recent years have been no exception. These relationships will become matters of more moment when government demand diminishes and private demand must come forward if the same level of production and employment is to be supported.

Contradictions in the Boom

The country is in a boom in the sense that debts are increasing; that demand for investment funds exceeds current money savings, large though savings are; and that people are borrowing to buy. It is in a boom in the sense that the need for labor in many places exceeds the supply; and that full employment invites demands for greater compensation for labor, which together with high turnover would tend to raise industrial costs. It is not in a boom, however, in the sense that speculation is active and forcing up prices, or that credit is being used for speculative purposes to an alarming extent. On the contrary, merchants are keeping commitments and stocks well proportioned to sales, and are emphasizing turnover. The tendency of industrial purchasing agents is to shorten rather than lengthen commitments. Basic commodity prices on the average have been in a sagging trend for more than two years.

These are some of the apparent contradictions in the economic situation which puzzle observers and policy makers alike. The moderation of industrial buying policies and of speculative activity generally is an element of strength in the outlook for which there is reason to be thankful. Policies now being followed are designed to restrict the growth of debt and expansion of the money supply. In the labor situation, on the other hand, new demands for wage increases and fringe benefits are coming forward.

Wage demands can no longer be supported by reference to a rising cost of living, since the consumers' price index has been in a sidewise trend since last August. The principal argument for increases now is that productivity has increased and that workers are entitled to the benefits. However, the balance in cost, price and income relationships, to which we have referred, will be sounder and the situation therefore

stronger if the benefits of increasing productivity in cutting costs go to no one group, but to all groups, which means that they should be fairly shared among workers, owners, and users of the product. If lower costs are translated into lower prices the benefits go to everyone. On the other hand, if labor takes all of the productivity gain, what is the effect on prices, trade and the capital supply to make work easier and unit production costs lower?

It is worth noting that the spread between the prices of things farmers sell and the things they buy, as measured by the so-called "parity ratio", has widened a little further. The eventual consequence of the development of price and income disparities is trade disruption. Balanced relationships, which must exist if business is to enjoy broad markets and labor is to have full employment, will be imperilled either by a rise in industrial costs, or by failure to share widely the benefits of industrial progress.

First Quarter Corporate Earnings

Corporate earnings reports thus far available for the first quarter of 1953 show increases generally in both sales and earnings as compared with the first quarter of 1952. With industrial production and trade this year reaching new postwar peaks, representative companies in many different lines established new all-time records. A substantial minority experienced, counter to the general trend, a downturn of earnings as the result of lagging sales, rising costs, or a combination of the two. High federal taxes, which took more than half of operating earnings in both years, had the effect of damping considerably the fluctuations — either up or down — in net income.

Our tabulation of 600 reports issued to date, representative mainly of the larger manufacturing organizations but including also a limited number of companies in the fields of mining, trade, service, and amusement, shows a combined net income after taxes of approximately $1,454 million. This represents an increase of 10 per cent over the initial quarter of 1952, with about two out of three companies reporting increases. As compared with the high fourth quarter of 1952, net income of the group this year was down 14 per cent, with two out of three companies having decreases. The level this year is around the same as in the first quarter of 1951, as may be seen from the following quarterly totals.

Net Income After Taxes of 600 Leading Corporations
(In Millions of Dollars)

	1951	1952	1953
First quarter	$1,491	$1,318	$1,454
Second quarter	1,468	1,250	
Third quarter	1,244	1,227	
Fourth quarter	1,507	1,691	

According to tax details given by a majority of the larger manufacturing companies, federal income and excess profits taxes took, on an average, 61 per cent of the income balance before taxes in both years. In making allowance for the excess profits tax which by existing law terminates on June 30 of this year, alternative methods of computation were used by different companies subject to the tax. Some companies explained in connection with their statements that they had applied to that portion of their income defined by law as "excess" the 30 per cent "basic" rate in effect by law until June 30. Others explained that, with such tax in effect only one half of this calendar year, they had applied only the "effective" rate of 15 per cent. Still other companies did not explain what method of tax computation had been used. Moreover, in many current reports the tax reserves are complicated, and reported net income distorted, by various adjustments and refunds provided under the revenue laws. Tax figures, and hence net income, may in some cases be subject to revision later when the fate of the excess profits tax is decided.

Aside from that tax, the regular corporate normal tax and surtax amounting together to 52 per cent stand unchanged and thus will continue to take over one half of corporate income.

A graphic picture of the impact of taxes was given to shareholders of the Union Carbide and Carbon Corporation at their annual meeting in the statement by Chairman Morse G. Dial that in the past three years, when the company's income was $733 million, some 55 per cent or about $407 million went for income and excess profits taxes. This, he said, was almost the same amount as the earned surplus of the corporation, which represented the earnings retained for expansion during Union Carbide's whole thirty-five year history.

Trends in Manufacturing

Of the 530 manufacturing companies which have reported to date, four out of five had increases in dollar sales billed over the first quarter of last year. Their combined sales were up about 15 per cent.

Following is a summary, partly estimated, of the overall operations of the manufacturing companies, while the accompanying table shows the changes in net income by major industry groups.

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

(In Thousands of Dollars)

No. of Cos.	Industry Groups	Reported Net Income After Taxes: First Qr. 1952	Fourth Qr. 1952	First Qr. 1953	Per Cent Change From: First Qr. 1952	Fourth Qr. 1952
27	Food products	$ 22,360	$ 32,742	$ 28,402	+27	—13
14	Beverages	10,676	16,430	11,357	+ 6	—31
11	Tobacco products	14,646	18,247	15,663	+ 7	—14
36	Textiles and apparel	14,383	19,859	19,873	+38	+....
24	Paper and allied products	25,376	29,070	25,676	+ 1	—12
37	Chemical products	138,155	161,552	149,436	+ 8	— 7
16	Drugs, soap, cosmetics	29,519	29,875	29,354	— 1	— 2
31	Petroleum producing and refining	415,726	443,741	412,989	— 1	— 7
31	Cement, glass, and stone	39,415	50,351	45,712	+16	— 9
38	Iron and steel	135,481	216,630	164,753	+22	—24
15	Building, heating, plumbing equipment	9,117	24,295	10,557	+16	—57
28	Electrical equipment, radio and television	54,492	91,533	78,331	+44	—14
43	Machinery	31,389	38,758	34,203	+ 9	—12
10	Office equipment	15,570	19,573	15,057	— 3	—23
14	Automobiles and trucks	139,752	189,298	165,789	+19	—12
26	Automobile parts	27,030	37,022	32,431	+20	—12
13	Railway equipment	14,170	15,634	14,865	+ 5	— 5
76	Miscellaneous metal products	107,851	142,217	124,440	+15	—12
45	Miscellaneous manufacturing	21,967	29,472	27,317	+24	— 7
530	Total manufacturing	1,267,075	1,606,299	1,406,205	+11	—12
28	Mining and quarrying	28,746	33,727	21,726	—24	—36
28	Trade (retail and wholesale)	14,041	41,661	17,665	+26	—58
14	Service and amusement industries	7,824	9,046	8,148	+ 4	—10
600	Total	$1,317,686	$1,690,733	$1,453,744	+10	—14

Although the manufacturing group's average net profit margin, as the summary shows, changed only from 6.0 cents per sales dollar in the first quarter of 1952 to 5.8 cents in 1953, the table giving changes by industry groups shows some highly uneven swings and among individual companies there were even sharper changes.

Outstanding gains in the first quarter over a year ago in both sales and earnings were registered by representative producers of automobiles and parts, electrical and television apparatus, building fixtures, and miscellaneous metal products. At the same time, some companies in industries such as machinery and equipment, which until recently had been working greatly expanded capacity overtime to meet the heavy demands for their products, showed a tapering off in sales.

Most textile manufacturers were able to make some recovery from the depressed conditions of a year ago, although a few were still operating in the red. Rising costs cut into the earnings of some companies in the food, beverage, tobacco, paper, petroleum, and other consumer goods lines which enjoyed little gain in sales, whereas other companies in the same lines were able to widen their profit margins from those of last year.

Sales and Net Income of 530 Manufacturing Corporations in the First Quarter

(In Millions of Dollars)

	1952	1953	Change Amount	%
Receipts from sales, etc.	$21,117	$24,241	+3,124	+15
Total costs, except taxes	17,895	20,648	+2,753	+15
Balance before taxes	3,222	3,593	+371	+12
Federal income & e.p. taxes	1,955	2,187	+232	+12
Net income	1,267	1,406	+139	+11
Taxes to balance before taxes	61%	61%		
Net income per sales dollar	6.0c	5.8c		

Retreat from Socialism

The above caption, in three words, epitomizes the real meaning of three major statements on budgetary policy last month by the top Treasury officials of the British and American Governments.

On April 14 the British Chancellor of the Exchequer, R. A. Butler, presented to Parliament his "incentive budget" for the 1953-54 fiscal year, calling for reduction in personal income and sales taxes as well as corporation levies, for the avowed purpose of encouraging individual and business effort and instilling new vigor and efficiency into production. On April 20 Secretary of the U.S. Treasury George M. Humphrey, in an address at New York, called for a halt to the inflationary spending and debt policies of the past twenty years, and declared the need for reduction of taxes and reform of the tax system to free the forces of private initiative and enterprise. On April 16 the Under Secretary of the U.S. Treasury, Marion B. Folsom, speaking at New York, discussed the tax problems, both immediate and long-range, on which they are working, and stressed, as did Mr. Humphrey and Mr. Butler, the objective of fostering incentives.

These pronouncements of high policy are significant of what the London Economist characterized as "a change of direction, a turn of the fiscal tide." It means moving away from the

socialist doctrine of ever-increasing government spending and taxing to guarantee jobs for all, to redistribute incomes, and progressively to take over from the citizens the power to decide what shall be produced and who shall get it. Instead, it means relying once more upon the operation of free markets and private endeavor. For those who believe in the freedom of the individual and in the capacity of the free enterprise system to serve man's material and spiritual needs, a fresh breeze is stirring in the world.

Britain's "Incentive Budget"

The budget which Mr. Butler announced to the British people embodies the boldest step the Conservative Government has yet taken to demonstrate its faith, proclaimed in the 1951 election campaign, in free enterprise, capitalism, and the profit motive. As we are reminded by New York Times correspondent Michael L. Hoffman, Sir Winston Churchill, in his first address to the nation after the election, compared the British economy to an express train speeding out of control on the wrong track. The Prime Minister explained to the people that the train had first to be brought under control and then it could be started again on the right track. Mr. Butler's new budget seems to mark that change of track.

Not only is this the first of Britain's postwar budgets to impose no tax increases, but it makes significant and widespread reductions in both direct and indirect taxes. "For the first time since the war – and high time it is –," declared the Chancellor, "we take a step in a new direction." The reliefs proposed are designed, he told the House of Commons, "to improve our competitive efficiency, to provide incentives for greater effort, and to encourage private saving." "We must," he stated, "banish the hopeless feeling that extra effort is not worthwhile."

To "lighten our burden and liberate our energies" Mr. Butler proposed a reduction of 2½ points to 45 per cent in the standard rate of income tax applying to both corporations and individuals, with additional concessions to the smaller individual incomes. The much criticized 30 per cent excess profits levy is to be terminated January 1 next, while the system of "initial allowances" on cost of new productive plant and equipment, suspended by the Labor Government, is to be reinstated immediately. At the same time the high purchase (sales) tax is to go down one-quarter at all levels – the new rates to be 75, 50, and 25 per cent, against the former 100, 66⅔, and 33⅓ per cent. The entertainments duty on certain sports will be abolished.

The new budget has been criticized in some quarters as too soft, both with respect to granting too large a share of tax concessions to consumption versus those going to industry and saving, and for accepting an overall deficit (including capital outlays) to be covered by borrowing. Mr. Butler has, however, taken cognizance of some slack in the economy and absence of inflationary symptoms. He has banked on a resurgence of output in response to the new incentives, with the weapon of monetary policy held in reserve and available to be used flexibly in support of budgetary objectives.

Whether the new proposals actually will prove to be the hoped for shot in the arm for the British economy is for the future to tell. But, as The Economist says, whatever criticisms may be made of their details, they have the great recommendation that they mark a determination to (quoting the Chancellor) "step out from the confines of restriction to the almost forgotten but beckoning prospects of freer endeavor and greater reward for effort."

Example in Canada

Though Canada's 1953-54 budget statement, rendered last February, was not mentioned at the outset of this article as significant of a "turn of the fiscal tide," nevertheless its emphasis on the incentive theme is pertinent to this discussion.

The fact is that concern for the welfare of productive industry and fostering of incentives is no new feature of Canadian budgets. Repeatedly the Canadian Finance Minister, Douglas C. Abbott, has voiced his apprehensions over the heavy tax burdens which circumstances have forced him to impose on individual and business enterprise. In line with this philosophy Canada right along has pursued a policy of spreading the tax load broadly through both direct and indirect taxes (including the sales tax, anathema to most American politicians), with the objective, as Mr. Abbott once put it, "to get a good balance between taxes on earnings and taxes on spending."

When the Korean war broke out and forced an upturn in defense preparations the Canadian Government raised the regular corporate tax rate but rejected reenactment of the World War II excess profits tax, on grounds, in the Finance Minister's words, of its inevitable "severe inequities" and its "invitation to extravagance and waste in corporate management." In his budget speech last year Mr. Abbott expressed his misgivings in these terms:

> Quite frankly, I am concerned that conditions make it necessary to maintain in our tax structure rates as high as this on business profits. My main concern is not with the current year or even possibly with next year. The ill

effects of too high taxes can perhaps be endured for a year or two. But as I said last year, excessive rates of tax on corporate incomes if long maintained can do grave damage to the economy as a whole, and I say quite candidly that if I had more leeway for tax abatement it is to income taxes, both corporate and personal, that I would give first consideration.

The new 1953-54 budget appears to have afforded Mr. Abbott the leeway for tax abatement he wanted. Reckoning the current account surplus last year at approximately $250 million, he turned first to "easing the strain" of the personal income tax. From July 1, 1953 the rates go down by an average of a little more than 11 per cent, with other liberalizing features.

A significant change affecting incentives was lifting the 10 per cent tax credit allowed to Canadian residents on dividends of Canadian corporations to 20 per cent – for the purpose of reducing double taxation of corporate earnings and encouraging Canadian investment in Canadian enterprise.

Recalling his oft-expressed concern over the "high level of taxes on corporate profits," Mr. Abbott lowered the rates, effective January 1, 1953, from the former 20 per cent of the first $10,000 of profits and 50 per cent on profits above that amount to 18 per cent on the first $20,000 of profits plus 47 per cent on amounts above $20,000.

This compares with U.S. federal corporate normal and surtax of 52 per cent on profits above the first $25,000, plus excess profits tax at 30 per cent.

To foster the discovery and development of mineral resources, tax relief or outright exemption is being continued, extended, and enlarged in various respects.

While taking the position that the general rate structure of the 10 per cent manufacturers sales tax, and of individual excise taxes, should remain unchanged for the present, the Finance Minister proposed a number of ameliorating changes, including a cut of 4 cents per package in the excise tax on cigarettes.

The ability of the Canadian Government to accord this tax relief reflects partly the dynamic growth of the Canadian economy. But primarily it is the result of good fiscal management. Canada in the postwar years has held closely to the path of financial rectitude, with balanced budgets and steady reduction of debt. Recognizing the dangers of attempting too much, her Ministers have insisted upon a fiscal policy of cutting the coat to suit the cloth.

The main point, however, that we wish to stress is the repeated evidence in Canadian budget statements of awareness by the fiscal authorities of the importance of preserving and encouraging incentives, both of individuals and of corporations, as illustrated by the following passage from Mr. Abbott's budget speech last February:

Income tax rates if too high can do harm in many directions. Tax laws should avoid placing too great a penalty on successful effort. Every reasonable incentive should be given to people to work hard, move to better-paid jobs, take risks and expand their business without keeping one eye continually on the tax-gatherer. This is particularly important in a growing and expanding country such as ours where there is so much to be accomplished.

Problems for the U.S.

Turning to the statements by Secretary Humphrey and Under Secretary Folsom regarding the budgetary problems in this country, neither included a formal blue-print of government receipts and expenditures such as in the budget speeches by Mr. Butler and Mr. Abbott. While our new Administration has been grappling vigorously with the task of formulating a new budget and working out a long-range tax program, there has been little time in its three months in office to arrive at definite figures or evolve detailed plans. The statements, nevertheless, are of importance as indicating guiding principles which may profoundly affect the destinies of the American people.

The situation of the United States, as pictured by Mr. Humphrey, may be likened to Sir Winston Churchill's description of the British economy, when the Conservatives took over, as an express train speeding out of control on the wrong track. As a result, the Eisenhower Administration and the American people find themselves with an inheritance of over $267 billion of national debt, of which far too much is short-term; outstanding government obligations and unsatisfied authorizations amounting to $81 billion; and a proposed budget for next year's expenditures in excess of $78 billion — $10 billion in excess of anticipated revenues. "We have," he declared, "a tax structure that is already so high that it is adding tremendously to our cost of living and threatening to destroy the incentive to work and save and invest."

Pointing out that our way of life can be lost just as completely by economic deterioration from within as by aggression from without, the Secretary asserted that "we must seek and find that delicate balance which will give us the necessary military preparedness against outside attack while always continuing to maintain our economic strength at home."

The First Task — Control Spending

The first task, as emphasized by both Mr. Humphrey and Mr. Folsom, is to regain control

of spending and balance the budget. Returning again to the British simile, we must first bring the train under control and then we can start it on the right track.

Talk of balancing the budget is an old story, but what we have heard in recent years from the administration in office has been mostly proposals for balancing it by raising taxes. Thus the call sounded by Messrs. Humphrey and Folsom for meeting the budget problem by curbing expenditures and reducing taxes does, indeed, mark a "turn of the fiscal tide." To be sure, it "cannot be done in a minute." Nor must essential defense requirements be jeopardized. But "more defense for less money is perfectly practical and a possible accomplishment."

The Secretary reaffirmed, as did Mr. Folsom, the position taken by President Eisenhower, that taxes should not be reduced until expenses are under control and a balanced budget is "in sight." That doesn't mean, Mr. Humphrey explained —

> that no relief from present taxation, which is far too high, can be anticipated. Just the opposite is true. Taxes must come down. It's simply a matter of timing geared to reduction of expense. Both are too high and both must be reduced. . . . Both should come down together.

Tax Reform Imperative

But control of spending and reduction of overall taxes are only part of the fiscal task outlined by Mr. Humphrey and Mr. Folsom. "Radical revision" of the tax structure is also necessary to provide incentive for the creation of more jobs and for the making of more, better, and cheaper goods.

Though there is still uncertainty as to when tax reductions can be made safely, "there is no doubt or disagreement," Mr. Folsom declared, "as to their desirability and to the direction of the first reductions." For one thing —

> It is not necessary to elaborate on the defect of the so-called excess profits tax. Almost everyone is agreed on this subject. Any long continuation of this form of taxation could not be justified because it is incompatible with healthy economic growth.

Also —

> A reduction in individual income taxes is of great importance because of the very heavy tax burdens now pressing on people at all income levels. . . . We want to return as much spending as possible from Government to private hands.

Looking beyond these two immediate problems, Mr. Folsom indicated the bent of Administration thinking by rejecting any concept of there being a "best" tax system. "No tax system," he asserted, "can be positively good. It is inevitably burdensome and restrictive. We can only hope to minimize the impact of the sacrifices and the consequences of the restrictions."

The main thing, he said, is to get the right balance between different major sources of revenue. Too great reliance on any single form of taxation is likely to lead to its breakdown, especially when rates are as high as today.

Conceding that the individual income tax should be looked to as the principal source of revenue, and a means of giving the desired degree of progression to the whole tax system, Mr. Folsom warned that such progression "should, needless to say, be based on reasonable judgments and not punitive or confiscatory."

Concerning the corporate income tax, Mr. Folsom's remarks were particularly forthright:

> This tax also may be pushed to a breaking point. Corporate profits, when distributed as dividends, are the necessary reward to the many millions of stockholders whose investments have provided the equity capital upon which our whole industrial system has been built. Without adequate dividends to justify continuing investments, we should have to look to a drying up of our traditional pattern of formation and expansion of industry. To the extent that corporate profits are not distributed as dividends, they constitute additional capital for expansion by existing successful companies. Thus, whether distributed or retained, reasonable legitimate profits are a part of the foundation of our whole economic system.
>
> The critical point in corporate taxation cannot be predicted in advance or determined with any high degree of accuracy. I suggest, however, that at rates around 50 per cent it becomes a major and not a minor factor in business considerations.

Implied in the above quotations is the need in this country for broadening the tax base to encompass greater reliance upon indirect taxation. Mr. Folsom specifically referred to the small proportion that excise taxes bear to total revenues here in contrast with other countries. He suggested that in the case of Canada the greater reliance upon indirect taxes was a factor in making possible the recent substantial reduction in Canadian income taxes.

New Grounds for Faith

Mr. Folsom went on to touch upon a number of the more detailed and technical aspects of different forms of taxation, including treatment of depreciation allowances, pension and retirement funds, capital gains and losses, and the like, which space limitations will not permit of review. What this article has sought mainly to bring out is the theme of these official statements as recognition of the importance of safeguarding incentive, both individual and corporate — the driving force of economic progress.

It has been a long time since sentiments of this nature have been heard in Washington.

Their utterance demonstrates all the more forcibly the "turn of the fiscal tide," and affords renewed grounds for faith in the kind of America that has been our tradition and heritage.

The 30-Year 3¼s

Moving to cover its cash requirements for the balance of the fiscal year, the Treasury on April 8 announced plans to raise approximately $1 billion by increased issues of 91-day Treasury bills and another billion by sale of thirty-year 3¼ per cent bonds. The Secretary also took the occasion to lessen the cash drain from early maturities of series F and G Savings bonds, twelve-year obligations which first went on sale in May of 1941. Holders of the $1.1 billion F's and G's coming due this year were given the opportunity, up to April 30, to convert their holdings into the thirty-year 3¼s. No figures are yet available on the success of this conversion offer. The $1 billion cash offering was quickly oversubscribed. The 3¼s at the close of April were quoted 99⅞ bid, 100 asked.

The new long-term bond, which departed hard-beaten paths of inflationary financing pursued by preceding administrations, evoked a lively protest for the extra strain it placed upon the investment market and for the rate of interest offered. Many critics failed to note that the basic problems for the Treasury lay in the existence of the deficit which requires increase in the public debt in a period of business boom; the misshapen structure of the debt which the Administration is pledged to improve; and the weight of other credit demands which the boom has generated. Under a sound money policy which excludes currency inflation to cheapen interest costs on the public debt, it was obvious that the Treasury could not have borrowed long-term money at a lesser rate than 3¼ per cent.

In the financial centers the news of the offering was received with mixed feelings. There was a wide recognition that the Administration was embarked on the only sound course of public policy. On the other hand, there was natural discouragement over this addition to the demands falling on the bond market, the associated markdowns in prices of bonds held in portfolio or inventory, the higher cost of borrowed money, and the unrelenting stringency in the money market. If there were any hopes that the Federal Reserve was going to relinquish its restrictive policy to dress up the bond market for a profitable turn, these were quickly dashed. As in the case of the $4 billion sale of 2⅜ per cent six-year bonds last July, the Federal Reserve held to the sidelines as a watchful observer.

$5 Billion Subscriptions

Although the books were open only two days, April 13-14, the cash subscription total ran up to $5¼ billion. While there was no question but that the investment interest was beyond the $1 billion mark, the subscription total was inflated by subscriptions from individual speculators, or "free riders", hopeful that the new bonds would immediately command a sizable premium. Also, some investors, aware that the speculative following the issue had attracted would result in a small allotment percentage, padded their subscriptions to get somewhere near the amount of bonds they wanted for their investment programs. On the other hand, subscriptions from commercial banks were limited to 5 per cent of their time deposits. Bonds were allotted at a rate of 20 per cent on subscriptions of $25,000 or more; $5,000 was allotted on subscriptions ranging from $5,000 to $25,000; and subscriptions for less than $5,000 were allotted in full.

Trading in the new bonds began on a "when issued" basis April 15 and became active when the allotment basis was announced on April 22. In spite of the evidence in the subscription figures of an unsated demand, the new bonds at no time during April commanded more than a ⅜ point premium in the market and on April 25-26, when bank loan rates were advanced, the bonds temporarily broke par to the extent of ¼ point. Thus, while most of the trading was in a range of 100 to 100¼, some speculators took small losses to unload. This market experience was a result of the reluctance of investors to pay premiums to get the bonds, the increases in bank loan rates, and the haste of "free riders" to get clear of their underwriting responsibility as rapidly as possible.

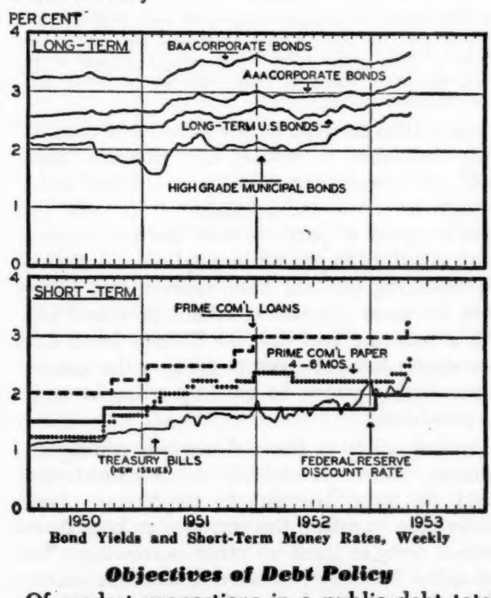
Market Developments

The need for the Treasury to borrow at this time is traceable to a failure of income tax revenues to reach expected proportions. While heavy borrowings over the July-December period had been foreseen, the need to borrow $2 billion so soon was bad news for the money and capital markets already laboring under strain. The Treasury initiated its increased borrowings on 91-day Treasury bills on April 23 when $1.5 billion new bills were sold against a maturity on that date of $1.4 billion. The combined weight of Treasury borrowing at both ends of the market — three months and thirty years — depressed the price scale for outstanding government securities straight across the board. It was hard sledding to distribute new municipal and corporate issues. Some issues were deferred because of the in-

crease in interest cost or because of unsettled market conditions.

In terms of yields, as the accompanying chart shows, the largest increase during April was in 91-day Treasury bills which went from an average rate of 2 1/16 per cent in March to around 2¼ per cent. Five-year Treasury bonds approached a yield basis of 2¾ per cent; ten-year 2⅞ per cent; and twenty-year 3 per cent. The protracted stringency in the money market brought advances from 2⅜ to 2⅝ per cent in prime 4-6 months' commercial paper, and from 2¾ to 3 per cent in Stock Exchange call money. The banks' prime commercial loan rate, which has been unchanged since 1951 when it rose ¾ per cent in three steps, was advanced from 3 to 3¼ per cent. The Commodity Credit Corporation advanced the rate charged on its loans from 3½ to 4 per cent. The Federal National Mortgage Corporation suspended purchases of mortgages pending Congressional review of its appropriation and reconsideration of the rates paid on the VA and FHA mortgages which it has been purchasing.

These rate changes are symptomatic of increased pressures on the savings supply and on lending institutions. They raise the cost on the dollar borrowed and the income on the dollar saved. They work to equate savings and investment and maintain a stable economy and a sound currency.



Bond Yields and Short-Term Money Rates, Weekly

Objectives of Debt Policy

Of modest proportions in a public debt total that runs to $265 billion, the thirty-year 3¼ per cent bond's main significance is as a pilot issue which reopens to the United States Government access to the long-term investment market. Apart from F and G Savings bond conversions, it is not a debt funding issue. Yet it breaks a path to regain control over the volume of floating indebtedness and in a gradual way to put the whole of the debt in more manageable shape.

Speaking of the new Administration's "legacy", at an Associated Press luncheon April 20, Secretary Humphrey referred to the inflationary policies pursued by preceding administrations:

> For several years past we have been treading a dangerous path, one from which we have now turned. It is not too late to make the turn and avoid the inevitable consequences for which we were directly headed. For twenty years we have been consistently following unhealthy policies that induced inflation, depreciated our currency and threatened to exhaust our credit. Over that period our dollar has shrunk from the hundred cents we started with to approximately fifty cents today. We have artificially manipulated our interest rates and have actually printed billions of dollars of current indebtedness which is only narrowly removed from printing money. . .

Stressing the need for "courageous, determined, corrective action" to forestall continuous deterioration in the value of money, achieve a sound currency, and foster free competitive enterprise, Secretary Humphrey set out as essentials (1) reduction in government expenditures and taxes; and (2) proper management of the public debt. On the latter point he stated:

> An equally important fundamental to preserve the soundness of our money and flourishing trade is the management of our huge debt. The way in which it is handled can also have an important bearing upon economic conditions and the creation of good or bad times. A stable currency is essential to an expanding level of employment and prosperity.
>
> If the debt is so managed as to increase unduly the available money supply, foster the over-extension of credit and depreciate the value of the dollar it can contribute greatly toward pushing us right back into the inflationary spiral of recent times.
>
> If, on the other hand, the debt is so managed that it drains the savings of the people too rapidly and in too large amounts so as to unduly restrict credit, depress prices and deprive industry of the funds required for full operation and expansion, then it can contribute to depression. Here again balance and timing are of first concern, and wise and careful handling of refinancing our enormous debt structure is of greatest importance.

The issuance of the thirty-year 3¼s, in this period of boom, fits Secretary Humphrey's prescription as a measure to limit over-extension of credit by dipping into the supply of long-term loan funds available to finance housing projects, industrial and public utility expansion, turnpike and other State and local government projects. There is no questioning the needs for housing, factories, public utility services, and highways. But if construction projects make excessive de-

mands on the stream of current savings they bring inflation and raise the costs of practically everything to everybody. The wisdom in the Treasury's approach is that it encourages pay-as-you-go to those who can finance without borrowing, and a stretching out or deferral of projects to those who must borrow to proceed.

The World War II Long-Terms

During World War II, under the combined influences of patriotism, shortage of other investment outlets, and the promise of par pegs, the public absorbed $36 billion in twenty-five year 2½ per cent Treasury bonds. This was an artificially low rate which developed out of the efforts to float the nation out of the depression on a sea of easy money. It was preserved during the war only by constant inflation of the currency through the Federal Reserve Banks. The low rate and long term made the War Loan 2½s vulnerable to price decline as soon as alternative investment opportunities opened up. Many of them had been bought on the understanding that their prices would be pegged at par or better, in effect guaranteeing the buyer 2½ per cent or better on a demand obligation.

The "commitment" to peg at par or better the 25-year 2½s plagued the Treasury and Federal Reserve authorities for six years after the close of the war. Of the $36 billion taken by the public, $9 billion were converted into 2¾ per cent non-marketable bonds at the invitation of the Treasury, and $5 billion wound up in the vaults of the Federal Reserve Banks and Treasury trust funds. The sellers got their money back for other lending at better rates, the credit supply to that extent was enlarged, and the anti-inflationary benefit of the original bond sales was correspondingly sacrificed. The $22 billion War Loan 2½s still outstanding in the hands of the public, recently have traded as low as 92⅛.

The plain fact of the matter is that 2½ per cent, fully taxable at steeply progressive rates, is not accepted by investors today as an adequate rate of return for long-term investment subject to risk of market price fluctuation. People of limited means buy Savings bonds and avoid the market risk. People of substantial means take fully tax-exempt bonds and common stocks. Even the 3¼ per cent rate, which some commentators described as "juicy", had its principal investment appeal among pension funds, mutual savings institutions, and life insurance companies which are in special tax categories.

Protests

The offering of the thirty-year 3¼s evoked many protests from people who variously argued that the Treasury should not have to meet the market but should dictate its own terms, that higher interest rates would make the cost of money exorbitant to borrowers, and that, in effect, a continued policy of currency inflation was essential to prosperity. A group of nine United States Senators on April 13 issued a joint statement which covered all of these points. They urged Secretary Humphrey to withdraw the offering and accused the Administration of having adopted a "new, high-interest, dear-money policy" which would be deflationary, cost the Government $225 million in unnecessary interest charges, and make credit more costly and less readily available to farmers, home buyers, business, municipalities, and borrowers generally. "The principal beneficiaries," they said, "of this unnecessary and gratuitous 30 per cent increase in long-term Government interest offering will be banks and insurance companies . . ."

Senator Morse of Oregon, amplifying the statement on the floor of the Senate, said in part:

> . . . Because of its tremendous weight and importance, it is ridiculous to talk about the Government being, so to speak, an equal competitor in the money market.
>
> . . . I think the argument about the increased interest rate being anti-inflationary is one of the most insincere and phony arguments I have heard in connection with the whole issue.
>
> . . . I do not deny that to some extent the increased interest rate will have some anti-inflationary effect, but in my opinion it is insignificant. It will not have nearly the effect that the recognition on the part of the people of their patriotic duty to set aside and take out of the stream of inflationary spending a certain amount of national wealth in terms of loose cash would have. That is our patriotic duty.

Since 1935 Savings bonds have been continuously available to attract the citizen's "loose cash". In recent years it has been difficult to sell enough to cover redemptions. It is well and good to speak of patriotic duty but Government also has a duty to pay off in good coin. Inflationary financing policies have been a tax, taking from the saver the rate of return promised him. It is a sobering fact that no Savings bond held to maturity has yet given to a buyer the amount of purchasing power he gave up when he made the purchase.

Present policy is directed towards ending this injustice. There is nothing the Administration could do more harmful to the Savings bond holder than to inflate the currency to keep down interest costs to itself on other borrowings. The action the Treasury has taken to meet the market on marketable bonds guards the buying power of the dollar from further shrinkage and makes the Savings bond a better holding and a better purchase.

The consequences of rigging the money markets to save the Treasury on interest charges have been explored in two Congressional investigations since the war, one headed by Senator Paul H. Douglas in 1949-50, and one headed by Congressman Wright Patman in 1951-52. The report of the Douglas committee had these findings:

. . . Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities.

As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

Who Benefits?

It is possible to calculate, as the nine Senators did, that the Treasury, in paying 3¼ per cent instead of 2½ per cent on $1 billion will incur an additional interest cost of $7½ million a year or $225 million over thirty years. No doubt the Treasury would have paid 2½ per cent if it had been possible to float an issue at this rate. But with Treasury 2½ per cent paper available at a discount in the market few buyers would have come forward. Pension funds need higher rates to meet their actuarial requirements; they buy common stocks if bond yields are inadequate. Savings banks need rates to give leeway above the 2½ per cent paid savings depositors. Life insurance companies, able to get a minimum of 3½ per cent on other investments, were only marginally interested in even a 3¼ per cent rate.

Statisticians of the CIO calculated that the higher rates on the public debt might "ultimately" cost the Government $1 billion or more in additional interest charges. Ultimately, of course, is a long time and no one can predict with any assurance what the debt and the interest charges will be many years hence. But, as Under Secretary of the Treasury Marion B. Folsom pointed out: "If we can help check this inflation, we will have saved the American people many times over the amount which the Government will have to pay in the increased interest rate on the bonds."

The 3¼ per cent rate, contrary to the view of the Senators, was neither "unnecessary" nor "gratuitous" nor are "the banks and insurance companies" the prime beneficiaries. Credit demands currently are sufficient to keep the resources of lending institutions abundantly employed — without deficit-financing demands by the Federal Government.

There are benefits from higher interest rates, in the first instance at least, to banks and insurance companies, not to mention pension funds, savings and loan associations, and lenders generally. But these institutions are intermediaries: apart from additions to reserves, which make them stronger, and Federal and State tax levies, the benefits are passed on. Bank payments of interest on deposits, the biggest single item of bank expense twenty-five years ago, dropped by five-sixths up to 1943. With the benefit of creeping advances in money rates over the postwar years and enlarged savings attracted by the better rates offered, interest paid bank depositors this year may be triple the 1943 figure. For a pension fund a ½ per cent increase in interest rate earned can over time reduce the cost by 15 per cent or correspondingly enlarge pension benefits. Better interest rates reduce the cost of life insurance — or give opportunity for a better insurance coverage.

These gains are not to any "favored few" but span out to the rank and file of citizens. Indeed, so far as they are the product of policies to defend the dollar, they give a breath of hope to the truly forgotten man in the recent age of inflation — the man struggling to live on a fixed income or on the income from a fixed fund of savings.

Pegs versus Free Markets

In a speech on "The Transition to Free Markets", on April 13, William McC. Martin, Chairman of the Federal Reserve Board, put the turn of debt policy into the perspective of the two years that have passed since bond price pegs were abandoned:

. . . There are still some who would have us return to a pegged market. If we did, we would have no reliable safeguard against the erosion of our savings, our pensions, our life insurance policies — the capital upon which the institutions of private enterprise rest. There are no reliable substitutes for free markets which have been reinstated during the past two years. A redundant money supply can be dammed up by direct controls for a time, but as we saw in the early postwar years, once the controls are lifted, as the public insists that they be in peacetime, the economy is engulfed with the flood of money that has already been created and only temporarily held back.

If we handle our fiscal, monetary, and debt management problems wisely we will not have to worry very much about the value of the dollar.

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